(5)

Supreme Court, U.S.
FILED
MAY 28 1999
OFFICE OF THE CLERK

No. 98-1612

In The

Supreme Court of the United States

DIAMOND MULTIMEDIA SYSTEMS, INC.,
WILLIAM J. SCHROEDER,
GARY B. FILLER and HYUNG HWE HUH,

Petitioners,

v.

SUPERIOR COURT OF SANTA CLARA COUNTY (*PASS*),

Respondent.

On Petition For A Writ Of Certiorari To The Supreme Court Of The State Of California

PETITIONERS' REPLY MEMORANDUM SUPPORTING THEIR PETITION FOR WRIT OF CERTIORARI

STEVEN M. SCHATZ
(*Counsel of Record*)
TERRY T. JOHNSON
THOMAS J. MARTIN
REBECCA A. MITCHELLS
WILSON SONSINI GOODRICH & ROSATI
PROFESSIONAL CORPORATION
650 Page Mill Road
Palo Alto, California
94304-1050
Telephone: (650) 493-9300
Facsimile: (650) 565-5100

JOSEPH A. GRUNDFEST
W.A. FRANKE PROFESSOR OF LAW & BUSINESS
STANFORD UNIVERSITY SCHOOL OF LAW
Crown Quadrangle
559 Nathan Abbott Way
Stanford, California
94305-8610
Telephone: (650) 723-0458
Facsimile: (650) 723-8229

Attorneys for Petitioners

COCKLE LAW BRIEF PRINTING CO., (800) 225-6964
OR CALL COLLECT (402) 342-2831

12pp

TABLE OF CONTENTS

Page

ARGUMENT 1

I. Plaintiff's Commerce Clause Argument Ignores The California Supreme Court's Own Words And The Record In This Case..... 1

A. This Petition Presents a Serious Commerce Clause Issue Because the California Supreme Court Held That Liability Under California Statutes May Be Imposed Simply Because A Statement Is "Willfully Disseminated" In California 1

B. This Case Properly Raises The Commerce Clause Challenge 3

II. Plaintiff Does Not Dispute That Section 25400 Conflicts With The Federal Reform Act 6

III. The Petition Raises Significant, Ongoing Issues That Warrant This Court's Review 9

CONCLUSION 10

TABLE OF AUTHORITIES

Page

CASES

Barnett Bank of Marion Cty, N.A. v. Nelson, 517 U.S. 25 (1996) 7

Stormedia, Inc. v. Superior Court, No. S062661, 1999 Cal. LEXIS 2973 (Cal. May 27, 1999) 3

PUBLICATIONS

James E. Day, *The Securities Litigation Uniform Standards Act of 1998: Solution or Stop Gap Measure?*, 13 Insights 17 (Feb. 1999) 9

ARGUMENT

I. Plaintiff's Commerce Clause Argument Ignores The California Supreme Court's Own Words And The Record In This Case

A. This Petition Presents a Serious Commerce Clause Issue Because the California Supreme Court Held That Liability Under California Statutes May Be Imposed Simply Because A Statement Is "Willfully Disseminated" In California

In her opposition to the Petition, plaintiff argues that the California Supreme Court's decision in this matter does not raise a Commerce Clause issue because that court interpreted Section 25400 to apply only to false statements that are physically made in California. But the California Supreme Court could not have been more clear in defining when a statement is made "in this state" under Section 25400. The Court held:

> If the statement is made by a person in California *or is willfully disseminated in California*, it is made "in this state."

Appendix A of the Petition for Writ of Certiorari, at page A21 (emphasis added). References to the Appendices bound with the Writ Petition are styled ("A___").

Plaintiff does not deny that this portion of the California Supreme Court's opinion gives Section 25400 a scope that violates the Commerce Clause. Rather, just as the Wizard instructed Dorothy to pay no attention to the man behind the curtain, plaintiff tells this Court that it should ignore the words "disseminated in California." Plaintiff apparently recognizes that if Section 25400 creates liability for out-of-state statements that are merely "disseminated in California," then Section 25400 imposes

an impermissible burden on interstate commerce. As defendants explained in their Petition, allowing a cause of action in favor of out-of-state plaintiffs against out-of-state defendants based on out-of-state statements that happen to be "disseminated in California" would allow California to regulate transactions that have no relation to the state in violation of the Commerce Clause. Petition at 12-13.

To avoid this constitutional violation, plaintiff tries to reword the California Supreme Court's decision. Under plaintiff's revision, the California Supreme Court really meant to say that Section 25400 creates liability where false statements are made in California and "where, although the defendant's statement might have been drafted elsewhere, it was published in and emanated from California." Respondent's Brief in Opposition at 8 ("Respondent's Br.") Plaintiff then points to other places in the court's opinion where it used phrases such as "in California" or "in this state" without using the words "disseminated in California."

Plaintiff's attempt to put words in the California Supreme Court's mouth is unsupportable. The court did not say a statement is made in California if it is "published in" or "emanates from" California. Rather, the court used the words "disseminated in California." Contrary to plaintiff's argument, this was not simply an inconsequential, casual slip appearing in a passing reference. The passage in question is the precise part of the opinion where the California Supreme Court explicitly defined what it means for a statement to be "in this state." This passage is the very heart of the court's interpretation of the "in this state" language in the statute.

Other references to "in this state" or "in California" are explained and defined in this passage.

Plaintiff says that defendants took the court's definition out of context to create a "parade of horribles." *Id.* at 7. Plaintiff refers to other parts of the opinion where the court referred to conduct in California. *Id.* at 8. But in none of these passages does the Court define when a *statement* is made in California. That definition is in only one place: the passage defining a statement "in this state" to be one that is made in California or "willfully disseminated in California." The court's words are what they are. Plaintiff cannot avoid the constitutional implication of those words by unilaterally rewording the opinion. The California Supreme Court's holding was that liability may be imposed for statements "disseminated in" California.

Just this week, the California Supreme Court itself rejected the opportunity to limit its holding that Section 25400 applies to all statements "disseminated in California." In *Stormedia, Inc. v. Superior Court*, No. S062661, 1999 Cal. LEXIS 2973 (Cal. May 27, 1999), the California Supreme Court emphatically reaffirmed its decision in this case. In fact, the court went even further in expanding the scope of the California statute. In effect, California has now created a nationwide securities law that has the scope of federal law without the corresponding limitations. This Court should accept review to strike down this statute, which is in clear violation of the Commerce Clause.

B. This Case Properly Raises The Commerce Clause Challenge

Plaintiff argues that the Commerce Clause challenge is not properly raised in this case. Plaintiff says that all of

the allegedly false statements were made by speakers who were physically in California. Plaintiff asserts that none of the alleged misstatements was made out-of-state and "disseminated" in California. Respondent's Br. at 9. Accordingly, says plaintiff, the question of whether the California statute unconstitutionally regulates interstate commerce is not presented here. Plaintiff is wrong for two reasons.

First, the record does not support plaintiff's assertion that all of the alleged misstatements were made by speakers who were physically in California. *Id.* at 9. This matter arises on a writ of mandamus from an order overruling defendants' demurrer to the complaint. The complaint does not state whether the alleged misstatements were made by speakers who were physically in California, or whether those statements were disseminated in California. For example, plaintiff alleges that defendants are liable for reports written and published by securities analysts. But plaintiff does not allege in the complaint whether these analysts were physically in California when they wrote, published and disseminated these reports, or whether the analysts were elsewhere but disseminated the reports in California. If the Commerce Clause allows the California statute to be applied to either type of statement, then plaintiff's failure to allege the location of the speakers is irrelevant and the complaint properly may proceed. Apparently, this was the view of the California Superior Court and the California Supreme Court: neither court considered the location of the speaker to be relevant, or they would have held that the demurrer should be sustained with leave to amend to allege the location of the speaker. But if the Commerce Clause invalidates the California statute to the extent it

regulates out-of-state statements, then a plaintiff may state a cause of action only by alleging that the false or misleading statements were physically made in California. This complaint fails to allege that the statements were physically made in California and therefore fails to allege this essential element of the cause of action. The defendants' demurrer therefore should have been sustained for failure to state a cause of action. Thus, the Commerce Clause issue is determinative of the viability of this complaint.

Second, defendants showed that under this Court's Commerce Clause jurisprudence, Section 25400 impermissibly burdens interstate commerce in four independent ways. Only one of those independent grounds, *i.e.*, that Section 25400 controls conduct outside of California, involves the location of the statements. Plaintiff's argument ignores the three other independent grounds, which do not depend on whether a statement is disseminated in California. Each of these remaining arguments is a facial challenge to the validity of Section 25400. Specifically, defendants showed that Section 25400 directly violates the Commerce Clause by regulating commerce outside of California and by having the practical effect of producing inconsistent legislation. Section 25400 also indirectly violates the Commerce Clause by allowing California indirectly to regulate interstate commerce. *See* Petition at 9-17. The location of defendants' statements is irrelevant to the resolution of these three independent facial challenges to Section 25400 under the Commerce Clause.

Accordingly, this case properly presents the Commerce Clause issue.

II. Plaintiff Does Not Dispute That Section 25400 Conflicts With The Federal Reform Act

In response to defendants' argument that the Private Litigation Securities Reform Act of 1995 impliedly preempts Section 25400, plaintiff offers a grab-bag of arguments. Remarkably, however, the one thing plaintiff does not do is deny that Section 25400 conflicts with the Reform Act. The existence of such a conflict is the central issue in any implied preemption analysis. By failing to address the conflict, plaintiff misses the whole point of the implied preemption issue.

The most egregious conflict between Section 25400 and the Reform Act involves the Reform Act's Safe Harbor for forward-looking statements. The Safe Harbor insulates from liability forward-looking statements accompanied by cautionary language or, where there is no cautionary language, requires that plaintiff show that the defendants actually knew that the forward-looking statements were false when made. *See* Petition at 24-27, A90-92. This is a substantive provision that lies at the heart of the Reform Act. The purpose of the Safe Harbor is two-fold: to encourage companies to disclose valuable information to investors and to prevent abusive lawsuits that create a chilling effect discouraging such disclosure. *See* Petition at 25. Plaintiff does not dispute that the federal Safe Harbor has no counterpart in Section 25400. Although plaintiff does assert that the complaint in this case contains allegations that meet the "actual knowledge" prong of the federal Safe Harbor, Respondent's Br. at 3-4 n.3, plaintiff does not – and cannot – contend that

state law contains any provision similar to the "cautionary language" prong of the Safe Harbor. Thus, liability may be imposed under state law for conduct that is insulated from liability by the federal Safe Harbor, defeating the two-fold purpose of Congress. This poses a direct conflict between state and federal law. Plaintiff does not contend otherwise.

Instead of addressing this conflict or any of the other conflicts between state law and the Reform Act, plaintiff argues that Congress did not expressly preempt state securities laws, instead choosing to leave state remedies available. Respondent's Br. at 9-11. That misses the point. The issue here is *implied* preemption. It is no answer to point to the absence of *express* preemption. Under implied preemption analysis, state law is preempted when it conflicts with federal law or when it stands as an obstacle to the purposes of Congress. *See* Petition at 17, citing *Barnett Bank of Marion Cty, N.A. v. Nelson*, 517 U.S. 25 (1996). Congress knew that. It did not need to include a provision in the statute that says "every state law that conflicts with this statute is hereby preempted." The absence of any such provision in the Reform Act does not mean there is no preemption.

Plaintiff likewise misses the point of implied preemption analysis when she argues that Congress intended the federal Safe Harbor to apply to liability under federal law only and intended to allow the states to provide additional protection for investors. Respondent's Br. at 12 n.10. While it may be true as a general proposition that Congress intended to allow concurrent operation of state law, Congress never intends to allow state law to conflict with and undermine acts of Congress. That is the essence

of implied preemption. Plaintiff fails to address that problem.

Plaintiff makes much of the fact that the Securities Litigation Uniform Standards Act of 1998 preempts certain state securities class actions prospectively, but not retroactively. Plaintiff leaps to the assumption that because the Uniform Standards Act expressly preempts state law on a prospective basis, then the earlier Congress, in passing the Reform Act three years earlier, must have intended not to preempt state law, regardless of whether the state law irreconcilably conflicts with the federal law. Plaintiff fails to offer one shred of support for this unfounded assumption. On the contrary, there is no evidence that the Congress that enacted the Reform Act intended to allow state laws that conflict with and undermine the Reform Act.

Plaintiff also argues that even if California law conflicts with the federal Safe Harbor provision, the complaint in this case would not be dismissed because it includes other allegations of false statements that were not forward-looking. Respondent's Br. at 12 n.10. Apparently, plaintiff is suggesting that if the California statute properly may be applied to part of the complaint, this Court should allow the statute to be applied unconstitutionally to the rest of the complaint. That makes no sense. The California courts have held that the California statute may be applied to forward-looking statements. If this is unconstitutional, the issue should be reviewed now.

Accordingly, this Court should accept review of the implied preemption issue.

III. The Petition Raises Significant, Ongoing Issues That Warrant This Court's Review

Plaintiff suggests that because of the newly-enacted Uniform Standards Act, state securities actions like this one that conflict with and undermine the Reform Act will soon be a thing of the past. Respondent's Br. at 4. But as defendants showed, there are gaping holes in the coverage of the Uniform Standards Act that will allow state securities actions to continue: the Act does not apply to actions on behalf of fewer than 50 persons, to claims against privately held companies or limited partnerships, to tender offers or proxy materials, or to shareholder derivative actions. Petition at 27-28; *see, e.g.*, James E. Day, *The Securities Litigation Uniform Standards Act of 1998: Solution or Stop Gap Measure?*, 13 Insights 17 (Feb. 1999) ("SLUSA is unlikely to stem the tide of class action litigation filed in state court to avoid the constraints of the Reform Act. Indeed, the structure of SLUSA presents ample opportunities for plaintiffs to continue to use state courts as the forum for such suits.") Plaintiff does not deny that these gaps in coverage exist and will result in continued undermining of the Reform Act.

Moreover, plaintiff ignores that state courts are inconsistently applying the Commerce Clause in determining whether the state securities laws impose an impermissible burden on interstate commerce. As the Petition, the dissenting opinion and even Respondent's Brief make clear, some state courts are applying this Court's Commerce Clause case law to strike down state securities statutes while others are interpreting this same

case law in the opposite way. Petition at 10, A55; Respondent's Br. at 6-7. This inconsistent application of the Commerce Clause touches not only state securities laws creating civil remedies as in this case, but also broker-dealer statutes, anti-takeover statutes and registration statutes. This inconsistency among the state courts will continue until this Court clarifies the application of the Commerce Clause in this context.

CONCLUSION

Petitioners respectfully request that the Court grant this petition.

Respectfully submitted,

STEVEN M. SCHATZ
(*Counsel of Record*)
TERRY T. JOHNSON
THOMAS J. MARTIN
REBECCA A. MITCHELLS
WILSON SONSINI GOODRICH & ROSATI
PROFESSIONAL CORPORATION
650 Page Mill Road
Palo Alto, California 94304
Telephone: (650) 493-9300
Facsimile: (650) 565-5100

JOSEPH A. GRUNDFEST
W.A. FRANKE PROFESSOR OF
LAW & BUSINESS
STANFORD UNIVERSITY SCHOOL OF LAW
Crown Quadrangle
559 Nathan Abbott Way
Stanford, California 94305-8610
Telephone: (650) 723-0458
Facsimile: (650) 723-8229

Attorneys for Petitioners